PRIVATISATION AND DEREGULATION: CORPORATE GOVERNANCE CONSEQUENCES IN A GLOBAL ECONOMY

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1. INTRODUCTION

Privatisation, deregulation, corporate governance and globalisation are four highly topical questions. Hence, we are going to discuss a situation in which all these issues have converged: the privatisation and liberalisation of the British electricity industry. Although it supposed the introduction of the standard corporate governance mechanisms, it is questionable whether these practices were effective in such a unique re-regulated environment. So, it would be reasonable to assume that global competition could play an important role in bringing in the appropriate incentives.

The paper is structured as follows: In section 2, we will briefly review the characteristics of the British electricity sector reform. Subsequently, the general problems of corporate governance in the privatised utilities are commented on in part 3, while the specific internal and external governance devices are presented in sections 4 and 5, respectively. Finally, we will draw some conclusions and policy implications in the light of globalisation.

2. THE SETTING[1]

In 1947, the electricity supply industry in England and Wales[2] was nationalised and amalgamated in two parts: an entity in charge of all generation plants and the transmission system; and, on the other hand, twelve Area Boards responsible for local distribution and supply of the electricity in their respective regions. With minor reforms, this system remained in place until 1990, when a radical structural and regulatory reorganisation was carried out. Soon afterwards, a privatisation process was initiated. All these changes are widely known as the "British electricity experiment" (Vickers and Yarrow, 1991) and can be summarised as follows:

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[1] A comprehensive and updated review of the issues can be found in Surrey (1996). See also Young, Shuter and Kuhn (1996); Armstrong, Cowan and Vickers (1994); or Bishop, Kay and Mayer (1994).
[2] This paper deals only with the electricity industry in England and Wales. In Scotland and Northern Ireland, the sector had, and still has, different structural configurations and regulatory regimes.

- The four main segments of the industry -generation, transmission, distribution and supply- were separated, in order to increase transparency and introduce competition where feasible.
- Generating capacity was divided among three new firms: two fossil-fuel generators and a third company owning the nuclear plants.
- The transmission network was detached from generation and assigned to the National Grid Company (NGC), which also ran the dispatching of power plants.
- The former Area Boards were renamed Regional Electricity Companies (RECs) and kept their geographical scope. But, they were required to operate their distribution and supply businesses as separate activities.
- Competition in the generation business was introduced through a wholesale power pool. In this market, generators and suppliers achieved co-ordination by means of spot prices.
- The supplying of electricity to final customers is being liberalised in three steps. At the end of the process (1998), all customers will be free to choose their supplier at market prices.
- Electrical networks -transmission and distribution- remained as monopolies, but the access has to be open to third parties on the basis of non-discriminatory terms. Tariffs for these transport services were subject to price cap regulation.
- The ownership of the NGC was transferred jointly to the RECs.
- The RECs and the two fossil fuel generators were privatised by public offers.

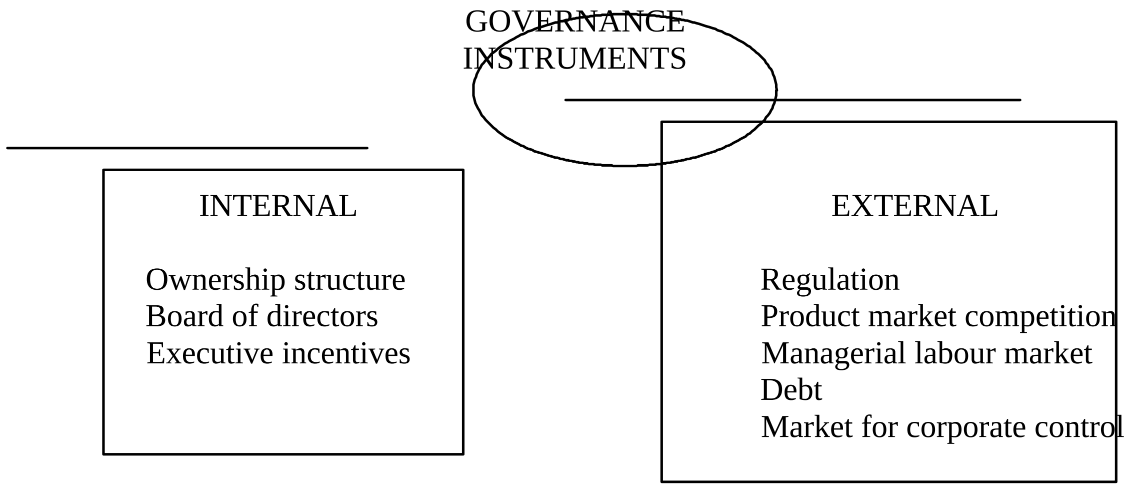
The twelve Regional Electricity Companies constitute an excellent population of firms for studying how corporate governance mechanisms have evolved after privatisation because: they were similar in size; they also had an equivalent resource endowment at the time of vesting -as a result of uniform policies and high mobility of human resources within the nationalised electricity industry-; and, even more important, they faced an identical regulatory regime.

3. CORPORATE GOVERNANCE IN THE PRIVATISED ELECTRIC UTILITIES

Managers of the nationalised electricity sector were given a generic mandate to act in the public interest. Nevertheless, they were subject to political control by their corresponding Government Department and, to a lesser extent, by Parliament. There were also consultative councils, in which consumers had a voice in the affairs of the industry. The statutes of the sector required the Boards to pursue break-even policies, balancing the results taking one year with another. In order to foster efficiency, this broad objective was progressively transformed into a series of formalised financial controls and restrictions -a target rate of return on net assets, an external financing limit or several performance objectives- (Chesshire, 1996). Of course, there was a strong possibility that civil servants could frequently slip up in monitoring managerial behaviour. At the same time, some strategic options -the nuclear programme and fuel/equipment supplier choices- were heavily conditioned by political decisions, with wider considerations than the economic results of the sector (McGowan, 1988). But excessive political intervention and vague and conflicting objectives were not the only problems of the old system -e.g. the lack of credible bankruptcy or acquisition threat; political determination of executive salaries; and absence of performance-related rewards (Kay and Thompson, 1986; Martin and Parker, 1997)-.

Two salient arguments for pursuing privatisation and deregulation were that (1) competition would create downward pressures on costs and prices, and (2) management would have more freedom to use their initiative (Secretary of State for Energy, 1988). The substitution of public controls for market forces will motivate directors to increase efficiency if, and only if, there is an adequate corporate governance framework. Despite electric utilities sharing some similarities with companies elsewhere in the private sector, their status as monopoly franchisees creates a unique set of incentives and restrictions (Ogden, 1997). In the next sections, we are going to analyse the different governance devices -both internal and external- and their influence on the RECs' executive actions.

FIGURE 1



4. INTERNAL GOVERNANCE MECHANISMS

Ownership Structure. Direct monitoring performed by owners is the most obvious governance device. A large shareholder has the incentive to collect information and exercise control in order to prevent opportunistic managerial behaviour (Shleifer and Vishny, 1986). On the other hand, highly diffused ownership stimulates free riding conducts (Grossman and Hart, 1980): the effort of a minority owner equally rewards all other shareholders. This asymmetric recompense discourages any attempt at supervision. For this reason, institutional investors -pension funds, unit trusts, insurance companies- are frequently encouraged to play a leading role in management oversight (Monks and Minow, 1991; Jensen, 1993). They have the knowledge, the experience and, usually, the power to assume this task (Pound, 1988).

The British government retained a golden share in each REC, redeemable no later than 31st March 1995. The consent of this special shareholder was required for the amendment of Articles of Association of companies. They included provisions preventing any person from having an interest in 15% or more of the capital. As table 1 shows, the largest shareholder rarely went beyond 10%. Moreover, the number of shareholders with interest of 3% or more, never exceeded the figure of 6.

Accordingly, it can be asserted that large holdings were infrequent. So, the absence of a leading investor could have induced free riding comportment.

TABLE 1: SUBSTANTIAL SHAREHOLDINGS

RECs	SHARE CAPITAL (%)			
	1992	**1993**	**1994**	**1995**
EASTERN				
Largest shareholder	6.38	5.99	6.12	6.11
Shareholdings > 3% (No)	9.38 (2)	17.44 (4)	9.55 (2)	16.20 (4)
EAST MIDLANDS				
Largest shareholder	4.83	4.83	4.75	4.74
Shareholdings > 3% (No)	11.02 (3)	7.83 (2)	4.75 (1)	4.74 (1)
LONDON				
Largest shareholder	5.02	4.99	4.85	5.13
Shareholdings > 3% (No)	14.85 (4)	16.48 (4)	14.84 (4)	11.32 (3)
MANWEB				
Largest shareholder	8.11	8.04	6.48	6.67
Shareholdings > 3% (No)	12.27 (2)	11.05 (2)	6.48 (1)	16.76 (4)
MIDLANDS				
Largest shareholder	9.89	9.33	5.14	5.75
Shareholdings > 3% (No)	14.66 (3)	12.37 (2)	8.26 (2)	9.42 (2)
NORTHERN				
Largest shareholder	7.03	8.01	6.01	6.41
Shareholdings > 3% (No)	19.74 (4)	16.45 (3)	6.01 (1)	6.41 (1)
NORWEB				
Largest shareholder	10.01	10.01	10.85	10.85
Shareholdings > 3% (No)	23.80 (4)	22.56 (4)	20.01 (3)	24.13 (4)
SEEBOARD				
Largest shareholder	5.52	7.10	6.62	5.78
Shareholdings > 3% (No)	26.84 (6)	24.19 (5)	11.36 (2)	10.52 (2)
SOUTHERN				
Largest shareholder	8.05	8.35	7.86	7.81
Shareholdings > 3% (No)	8.05 (1)	8.35 (1)	7.86 (1)	7.81 (1)
SWALEC				
Largest shareholder	14.9	5.20	5.2	6.00
Shareholdings > 3% (No)	29.00 (4)	22.60 (6)	14.00 (3)	22.20 (5)
SWEB				
Largest shareholder	10.6	10.20	11.52	12.20
Shareholdings > 3% (No)	22.1 (3)	25.60 (3)	11.52 (1)	15.90 (2)
YORKSHIRE				
Largest shareholder	5.15	8.15	4.84	4.93
Shareholdings > 3% (No)	15.17 (2)	21.98 (4)	8.60 (2)	8.45 (2)

Source: RECs Annual Accounts

Boards of Directors. The power of decision in large corporations has been progressively moving from stockholder meetings to boards of directors. Therefore, the composition and functioning of this organ have generated considerable attention, as it represents the key instrument for increasing control over management (Zahra and Pearce, 1989; Johnson, Daily and Ellstrand, 1996). However, it is often claimed that senior corporate executives dominate the boards and they do not act in accordance with their fiduciary duty, but rather their own interests.

In recent years, there have been several proposals to ameliorate this problem. Undoubtedly, the most influential was the Cadbury's Report (CFACG, 1992), which suggested a code of good practice for British boardrooms. The Committee, which produced the report at the end of 1992, was set up at the instigation of the London Stock Exchange and the accountancy profession. The key recommendations were:

- Clear division of responsibilities at the head of the company -e.g. separation of chief executive post from board chairman-.
- Increasing non-executive weight in board composition -with at least three non-executive directors-.
- Assigning non-executives a leading role in controlling functions. The board should have: (1) an audit committee, composed of at least three non-executives; (2) a remuneration committee, made up wholly o mainly of non-executives; and (3) a nomination committee, with majority of non-executives.
- Correcting board accountability deficit by including in annual reports details of their functioning, established committees, remuneration and possible conflicting interests.

All RECs welcomed the Cadbury Report and expressed their commitment to fully comply with the recommendations. It can be appreciated that board sizes decreased slightly after the publication of the report, maybe in an attempt to improve their effectiveness -average size dropped from 9.83 in 1992 to 9.25 in 1995. As far as board composition is concerned, we can observe in table 2 that, although all companies met the requirement of having at least three non-executives prior to the report, their weight has grown since then from 42% to 49%. Regarding the delimitation of responsibilities, most RECs used to have a chairman with executive duties, but, in line with the recommendations, there has been a separation of the chairman and chief executive posts. However, in many cases, it is not so clear that the former is a truly non-executive director. Likewise, all companies have established auditing, remuneration and nomination committees, complying with the prescriptions of the Code -in fact, most of them have done so prior to the report-. From all this, it follows that non-executive directors have achieved considerable power in REC boards, particularly in the control function. Added to that, there has been a noticeable increase in the amount and quality of corporate governance information released in the annual reports.

TABLE 2: BOARD SIZE AND COMPOSITION

	1992			1993			1994			1995		
RECs	**NE**	**E**	**SEP**	**NE**	**E**	**SEP**	**NE**	**E**	**SEP**	**NE**	**E**	**SEP**
EASTERN	5	7	No	5	6	No	4	7	Yes	6	7	Yes
E. MIDLANDS	4	6	No	4	4	No	4	4	Yes	5	4	Yes
LONDON	4	5	No	5	3	Yes	5	5	Yes	3	5	Yes
MANWEB	4	6	No	5	5	Yes	6	6	Yes	4	5	Yes
MIDLANDS	4	6	No	5	4	Yes	5	4	Yes	5	4	Yes
NORTHERN	4	4	Yes	4	4	Yes	4	4	Yes	4	4	Yes
NORWEB	3	6	No	5	6	No	4	6	No	4	5	No
SEEBOARD	5	6	No	5	7	Yes	5	6	Yes	6	6	Yes
SOUTHERN	5	4	Yes	5	4	Yes	4	4	Yes	4	4	Yes
SWALEC	5	5	No	4	6	No	5	5	Yes	5	5	Yes
SWEB	3	7	No	4	5	Yes	4	4	Yes	4	4	Yes
YORKSHIRE	4	6	No	4	6	No	4	5	No	4	4	No

NE: number of non-executive directors / E: number of executive directors / SEP: separation of Chairman and Chief Executive posts

Source: RECs Annual Accounts

Executive incentives. Apart from increasing supervision, owners have another instrument for aligning managers' goals: linking their remuneration to an accounting or market measure of the company results. Therefore, the compensation policy is something other than a fiscally efficient way of paying salaries. It can be seen as a governing device frequently used to reduce agency costs (Thompson, 1988; Joskow and Rose, 1994). But this tool has various limitations. Firstly, it could take a long time before a decision is reflected in the profit and loss account. Secondly, changes in the environment add to the already existing causal ambiguity. And finally, managers will modify their conduct to increase the amount of bonus -reducing depreciation charges or R&D investments-, even if it is against the long term interest of the shareholders (Hoskisson and Hitt, 1990).

It is often claimed that reward packages awarded to directors of privatised utilities have increased unjustifiably (Williams, 1995; Keenan, 1996). Table 3 reports the evolution of total emoluments[3] received by REC boards. It is undeniably true that most companies extended retributions in global terms. Taking into account the reduction in the number of directors per board and the greater weight of non-executives, it is possible to conclude that average individual compensations have grown during the period.

[3] Excluding share options schemes.

TABLE 3: DIRECTORS EMOLUMENTS

	1992		1993		1994		1995	
	Total emoluments (£ ,000)	**bonus in %**	**Total emoluments (£ ,000)**	**bonus in %**	**Total emoluments (£ ,000)**	**bonus in %**	**Total emoluments (£ ,000)**	**bonus in %**
EASTERN	1,095	-	1,309	2.9	1,620	17.7	1,529	12.4
E. MIDLANDS	1,056	12.6	1,182	4.5	1,140	5.8	1,287	37.9
LONDON	983	5.1	1,038	3.9	1,272	8.6	1,177	9.0
MANWEB	934	11.7	1,041	18.0	986	18.25	986	7.6
MIDLANDS	1,000	-	1,000	-	1,029	7.6	925	8.9
NORTHERN	632	4.1	775	10.0	986	7.2	1,167	14.0
NORWEB	850	0	880	6.8	920	8.6	1,350	8.9
SEEBOARD	946	0	1,000	0	984	0	1,140	0
SOUTHERN	962	10.9	1,067	14.1	987	11.2	974	9.03
SWALEC	1,213	8.8	998	11.7	1,005	13.7	1,003	12.6
SWEB	1,134	14.7	941	14.2	926	11.23	871	12.7
YORKSHIRE	1,000	0	1,049	0	878	7.7	1,070	20.0

Source: RECs Annual Accounts.

Nevertheless, this growth was not general and the variance might be due to the existence of different remuneration policies. Following privatisation, RECs introduced executive incentive schemes. All companies, except Seeboard, present some kind of short term bonuses, though performance criteria vary considerably among firms: earnings per share rise, share price growth, share price growth in relation to other RECs, electricity prices, achievement of customer services standards, reduction in controllable costs, personal objectives, ...etc. As can be seen in table 3, the proportion of rewards due to bonuses has notably increased -from 8.9% in 1992 to 13.1% in 1995, on average-. Similarly, long term incentives -in the form of share option programmes- are universally used by RECs and have acquired greater importance in directors' compensations. This expansion could be partly explained by the fact that granting an option has not had an immediate impact on the results and the amount of the reward is not noticed by the shareholder until it is exercised.

5. EXTERNAL GOVERNANCE MECHANISMS

Regulation. Conventional regulators act as active monitors of the firms under their control (Demsetz y Lehn, 1985). Indeed, systematic supervision exercised by regulatory bodies precludes directors from undertaking risky actions. Strategies such as diversification or internationalisation are frequently blocked or restricted by suspicious regulators.

The British regulatory reform was based on prices, in order to minimise the burden of intervention and to provide a clear and stable framework (Armstrong, Cowan and Vickers, 1994). Charges for using electrical networks are capped by the Director General of Electricity Supply, according to the RPI-X formula, for four or five year periods. This approach does not allow any cost passthrough and the regulator is not involved in examining internal policies of the companies. Therefore, during the regulatory lag -once tariff increases are established-, the regulators will have little power to control management behaviour. All this goes to show that REC directors enjoyed much greater autonomy than they would have under traditional rate of return regulation.

Product market competition. In a perfectly competitive market, there is no place for management discretion. Executive opportunism would send to stockholders a signal of lack of (Tirole, 1988). Otherwise, if the firm earns monopolistic or ricardian rents, directors can satisfy principal expectations and, at the same time, employ the extraordinary results in their own benefit.

The first liberalisation steps involved a sudden emergence of competition in electricity supply (Littlechild, 1995). Both established generators and second-tier suppliers entered traditional REC geographic areas and got substantial market shares. Although deregulation is still not completed, competition is so vigorous that results in this segment are frequently negligible or negative. Notwithstanding, the main business of the RECs is still distribution. As it is a natural monopoly, economic regulation -in the form of price controls- is in place. At vesting, X efficiency factors were set high to ease privatisation and to allow RECs to carry out all their necessary investments. But, RECs heavily pursued cost-cutting and downsizing strategies and, consequently, their profits grew steadily until 1995, when prices were reviewed. So, monopoly status plus imperfect regulation implied high rents, which allowed executives to comfortably meet shareholders demands and spend the surplus on their own objectives.

Managerial labour market. A transparent and competitive labour market would adjust ex-post any irresponsible behaviour (Fama, 1980). When a manager is fired, his human capital devalues. As executives give special attention to their reputation, they will avoid any action which could spoil it, even when there are no explicit incentives (Holmstrom and Tirole, 1990). But it would be generally acknowledged that this labour market is not efficient -at least, in a strong form. There could be some place for opportunism. Unfortunately, there is no hard data to confirm this point..

Debt. Agency theory presents debt as perhaps the strongest governance device (Jensen, 1986; 1989). The firm is contractually bound to pay the interests and redeem the principal. In case of default, creditors could claim a bankruptcy, and directors would lose their posts. Consequently, debt denotes a strong commitment, in comparison with equity. It reduces the amount of free cash flow available to managers, forcing them to disgorge cash rather than waste it.

TABLE 4: DEBT/TOTAL ASSETS RATIO

	1992	1993	1994	1995
EASTERN	0.36	0.33	0.38	0.55
E. MIDLANDS	0.44	0.41	0.40	0.42
LONDON	0.31	0.33	0.37	0.39
MANWEB	0.25	0.23	0.25	0.23
MIDLANDS	0.33	0.38	0.36	0.40
NORTHERN	0.31	0.29	0.30	0.38
NORWEB	0.23	0.25	0.28	0.35
SEEBOARD	0.33	0.32	0.37	0.30
SOUTHERN	0.42	0.42	0.35	0.33
SWALEC	0.31	0.29	0.24	0.28
SWEB	0.37	0.34	0.33	0.38
YORKSHIRE	0.36	0.45	0.39	0.51

Source: RECs Annual Accounts.

The net indebtedness of the industry under public ownership was very small. For this reason, as part of the 1990 reform, the government put £2.8 bn of debt into the liabilities of the RECs, to be repaid to the Treasury. Even after this financial operation, REC balance sheets remained healthy during the whole period, with low leverage ratios -see table 4. The remote likelihood of bankruptcy and the light scrutiny of debtholders did not force directors to provide justification for their actions.

Market for corporate control. The market for corporate control (Manne, 1965) represents the last external governance device. Given that it is extremely onerous, it will be utilised as the ultimate resort when all others have failed. Hostile takeovers are usually activated in case of poor performance and the incumbent management team is replaced. However, the disciplinary effect of takeover bids may be hindered by managerial defence manoeuvres (O'Sullivan, 1997). These tactics have increased in sophistication and variety -elimination of cumulative voting, anti-takeover amendments, dual-class recapitalisation, repurchases, poison pills, golden parachutes, defensive restructuring, etc.- and, in many cases, they overlap. Thus, the market will not work properly if managers are able to entrench (Dann y DeAngelo, 1988).

As has been previously commented, the State held golden shares in the RECs up to March 1995. They permitted the government to block any takeover and, in fact, precluded the market for corporate control to operate. However, a few months before redemption, the first hostile takeover arose. The British conglomerate Trafalgar House bid for Northern Electric, but the proposal was soon afterwards withdrawn, in the face of the defence package launched by the directors. Since then, we have witnessed strong takeover activity (see table 5). Foreign companies, established generators and water companies were among the anxious bidders.

This process re-opened the Pandora's box of the structure and regulation of the industry, as it raised many important issues. Firstly, if the bid comes from a company of another regulated industry -e.g. water distribution, there will be potential synergies that could benefit both consumers and shareholders. But, regulatory control might be more difficult and will require co-ordination between regulators. Secondly, there is also a conflict if the acquisition implies vertical integration, because it could reduce effective competition. Again, collisions with the regulatory agency could emerge. Thirdly, when the outcome is horizontal integration, yardstick competition in distribution will suffer, as the number of benchmarks decreases; and, on the supply side, it will diminish customer options. If generators, other electricity companies and water monopolies do not seem to be easy partners -in regulatory terms-, someone else should play the beneficial role of bidding for inefficient firms. Since financial conglomerates are becoming rare in a decade characterised by restructuring and divestitures, only foreign firms can be a real threat to the existing management team. In fact, 8 out of 12 RECs are now in the hands of USA electric utilities.

TABLE 5: TAKEOVER BIDS

REC	BIDDER			AGREED between parts		APPROVED by DTI		DATE
				Yes	No	Yes	No	
NORTHERN	Trafalgar House	conglomerate	UK		√			Dec 94
SWEB	Southern Company	electric utility	USA	√		√		Jul 95
MANWEB	Scottish Power	electric utility	UK	√		√		Jul 95
EASTERN	Hanson	conglomerate	UK/USA	√		√		Jul 95
NORWEB	North West Water	water utility	UK	√		√		Sep 95
MIDLANDS	Power Gen	generator	UK	√			√	Sep 95
SOUTHERN	National Power	generator	UK	√			√	Oct 95
SEEBOARD	Central & South West Corp.	electric utility	USA	√		√		Nov 95
SWALEC	Welsh Water	water utility	UK	√		√		Dec 95
MIDLANDS	Avon Energy (GPU + Cinergy)	electric utility	USA	√		√		May 96
NORTHERN	CE Electric (CalEnergy + PK)	electric utility	USA	√		√		Oct 96
E. MIDLANDS	DR Inc.	electric utility	USA	√		√		Nov 96
LONDON	Entergy Corp.	electric utility	USA	√		√		Dec 96
YORKSHIRE	Yorkshire Hold. (AEP+ PSC)	electric utility	USA	√		√		Feb 97
EASTERN (Energy Group)	Pacificorp	electric utility	USA	√		√		Jun 97

Source: Based on Electricity Association chronology.

To sum up, following privatisation, the external governance instruments did not put enough pressure on the managers of the RECs. A soft price regulation, the lack of product market competition in distribution, the low financial leverage and the deactivated takeover market created a stable and quiet environment. Moreover, diffused ownership was not an adequate stimulus either. Although board structures complied with best practices and executive incentives were in place, directors had large amounts of free cash flow which they spent on salaries and unprofitable diversification projects.

6. EPILOGUE: CORPORATE GOVERNANCE AND GLOBALISATION

Competition is the key mechanism for maximising efficiency and consumer benefits. It requires rivalry and/or freedom to enter the market. Two ways of achieving this aim are privatisation and deregulation. That is the reason why most -if not all- Western governments have been including both policies in their agendas. However, generally speaking, these instruments have been implemented in a quite nationalistic manner. Politicians are frequently reluctant to sell public assets to foreign companies. On the other hand, liberalisation norms tend to benefit domestic agents at the expense of enterprises from other states. Due to the small size of many home markets, privatisation and deregulation efforts do not necessarily give rise to effective competition in product markets. Thus, opening the economy might be essential to avoid private monopolies or oligopolies.

Another way of looking at this question is that nationalistic approaches may also distort the balance of power within firms. Electricity companies are still considered "strategic" assets by many States. If the market for corporate control was locked for foreigners, there could not be any company with the required resources for acquiring the inefficient agent. In that case, managers would not face the appropriate incentives for improving efficiency and shareholder wealth. The present paper argues that allowing USA electric firms to bid for their UK counterparts has brought to light and corrected inadequate corporate conduct. Previous shareholders enhanced their wealth, while the regulator got reliable information about the real value of the firms.

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